Faculty of Taxation

Tax Representation

TAXREP 6/04

INCOME TAX: MEANING OF UK SOURCE FOR PAYMENTS OF INTEREST AND ROYALTIES

Text of a memorandum submitted in February2004 by the Tax Faculty of the Institute of Chartered Accountants in England & Wales to the Inland Revenue in response to the Consultation Document published in December 2003.

INCOME TAX: MEANING OF UK SOURCE FOR PAYMENTS OF INTEREST AND ROYALTIES

INTRODUCTION

1. We welcome the opportunity to respond to the Consultation Document issued by the Inland Revenue in December 2003. This proposes the introduction into UK domestic law of a rule that a payment of interest or royalties is deemed to have its source in the territory where the payer is resident. A similar rule applies for the purposes of the EU Interest and Royalties Directive adopted by the Council of the European Union in June 2003, which comes into force on 1 January 2004 and whose implementation in the UK is the subject of a separate consultation exercise.

WHO WE ARE

2. The Institute is the largest accountancy body in Europe, with more than 128,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.

3. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department of Trade and Industry (DTI) through the Accountancy Foundation. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy (which includes taxation).

4. The Tax Faculty is the focus for tax within the Institute. It is responsible for technical tax submissions on behalf of the Institute as a whole and it also provides various tax services including the monthly newsletter 'TAXline' to more than 11,000 members of the ICAEW who pay an additional subscription.

COMMENTS

5. While we are attracted by the idea of a simple objective test to determine the source by reference to the tax residence of the debtor we are not convinced that it is appropriate to abandon the existing principles which are well understood and do not give rise to significant difficulties in practice. These principles are clearly enunciated in the Interpretation published on page 100 of Issue 9 of *Tax Bulletin* of November 1993.

6. Money, and debt, are fungible assets. Under the proposed new source rules it may be difficult in practice to determine the source of the loan. For example, if a UK company with several non-UK Permanent Establishments borrows from several lenders it may be extremely difficult to determine which loans are used by which part of the UK company and so to decide which loans have a UK source.

7. Indeed in other circumstances if the source of a debt is deemed to be in the UK because the debtor is resident in this country this may be the only connection with the UK.

8. On balance we would prefer to keep the existing 'rules' as they are both well understood and seem to produce satisfactory results.

SPECIFIC QUESTIONS

9. There are a number of specific questions in section 7 of the Consultation Document which are dealt with below. We have answered them on the basis that the proposals will be introduced despite the comments we have made above.

7.1 Are respondents in favour of adopting a definition of UK source aligned with the OECD model tax convention?

10. We have reservations as set out in paragraphs 5 to 8 above.

7.2 Do respondents foresee any issues about adopting a definition based on place of residence of the payer?

11. See our answers to the other questions for some of the issues.

7.3 What problems might arise where UK residents currently pay non UK source interest?

12. We believe that there should be 'grandfathering' arrangements for existing loans. The lender will often impose a condition on the borrower under which the borrower is required to bear the cost of any withholding and this might be triggered by the current proposals.

7.4 How would the definition impact UK permanent establishments or partnerships with some non-resident partners?

13. There are a number of UK registered LLPs where all the partners are non UK resident. The LLP might have no UK presence and we do not believe it would be appropriate to impose a withholding in respect of any interest or royalties paid by such entities. It is therefore important that a UK-registered LLP should not be deemed to be a resident entity for this purpose irrespective of the residence status of the members.

14. Similarly if an LLP or ordinary partnership has some UK based and some non UK based partners there would need to be some clear and certain way to determine whether or not the entity was to be treated as being a UK based debtor in respect of any borrowings the entity might have. Any rule requiring withholding to be applied to the proportion of the payment which is attributable to the resident partners would be impracticable.

15. We are also concerned about the position of a UK company with an overseas permanent establishment (PE). Would interest paid by the PE be treated as having a non UK source under the proposed new source rules? Under the relevant Double Tax Agreement it almost certainly would be so treated and the Consultation

Document indicates in the converse situation, a UK PE of a non resident company, the PE would be treated as a separate entity resident in the UK. However the document does not explicitly address the case of the overseas PE, and treating it as a separate non-resident entity would be a departure from the general rule of treating the place of residence of the payer as the source. We would welcome confirmation of the situation of the UK company with the non resident PE.

7.5 What would be the effect of extending the definition to interest paid by non resident landlords?

16. Extending the definition to interest paid by non resident landlords would go against the principle of deduction by reference to the residence of the debtor. In some cases under the existing law the interest would be regarded as having a UK source but seeking to retain that position when the residence of the debtor is normally the determining factor would seem to be 'to have one's cake and eat it'.

7.6 Should the definition be extended to apply to annuities and other annual payments?

17. It would be reasonable to do so for the sake of consistency.

7.7 How long would payers need to adapt their systems and would a start date of Royal Assent allow sufficient time?

18. It seems to us to be less a question of time to adapt systems and more a question of the fairness of applying any new arrangements to existing loans at all. Any new system must provide sufficient transition i.e. grandfathering for existing arrangements.

IKY
10 February 2004